REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION

January 30, 2007

Dear Mr. Secretary:

Since the Committee's previous meeting in November, the economic expansion has strengthened somewhat from the slow pace that prevailed last spring and summer. The consensus for the quarter just ended estimates that overall growth reached 3% or better despite another steep drop in homebuilding and related activities. Consumer spending responded vigorously to a sharp fall in energy costs and a highly promotional holiday season. Although a mild start to the winter may have provided an additional temporary boost to activity, confidence is rising that growth in coming quarters will moderate close to trend barring major spillover from soft housing markets to consumers.

Weakness in housing and autos in the second half of last year contributed to reduced price pressures toward year end. Prices of light vehicles and other large household goods declined at a 4% annual rate in the fall, helping to shave a couple of tenths off year-to-year increases in core inflation rates. The more recent fall in energy prices should also diminish or even reverse the earlier threat of pass-through effects to core inflation. Nonetheless, underlying inflation remains slightly elevated in a 2¼% to 2¾% range, while resilient hiring demands in a tight labor market and some indications of rising labor costs have kept alive concerns about upside risks.

Against a backdrop of tentative signs that an overbuilt housing market has begun to clear without sizable collateral effects on the broader economy, earlier expectations for lower interest rates in 2007 have faded. Yields on U.S. Treasury securities have risen by roughly 40 basis points above their late November lows and market participants now expect very little activity by the Federal Reserve over the medium term horizon.

The Federal government's fiscal balance continues to narrow. Fiscal year 2007 budget flows thus far point to another decline in the deficit this year. Continued economic expansion joined with the equity market's rise should support tax receipts, but public spending, especially on entitlements, also remains brisk.

In the first section of the charge, Treasury solicited the Committee's view on the fiscal outlook and whether the continued positive surprises on tax receipts and the overall deficit warrant any change in the debt issuance schedule.

The Treasury reviewed a series of exhibits with the Committee that highlighted the elevated tax receipts from corporations and individuals and the fact that recent figures on corporate profits, stock prices and employment suggest that these trends should continue over the near term.

At the same time, however, the Treasury also provided charts on the US housing market and recent volatility in oil prices that serve as a reminder of the uncertainty of future economic activity and tax revenue.

Members were quick to point out that while recent tax revenues have been tremendous, the ability to forecast tax revenues, expenditures and the Federal deficit is difficult and Treasury needs to be cautious not to extrapolate the recent success too far into the future. In fact, several members agreed that the demographic effects from entitlement spending will likely put significant strains on the budget beginning in less than a decade and that Treasury should be cautious in making any radical changes to its coupon issuance resulting from near-term trends.

Another member highlighted the confusion over the role of the alternative minimum tax (AMT) and its significance to recent surprises in tax revenue. And that, with the uncertainty surrounding the election season on this and other tax and spending issues suggests caution with respect to forecasting the deficit over the intermediate term.

The continuation of outsized tax receipts has improved market forecasts of the US budget deficit for fiscal year 2007 by approximately $75 billion. Committee members discussed what actions the Treasury might take in response to the continued reduction in net borrowing needs.

Most members agreed that the security with the least investor value was the 5-year TIPs. While, overall, TIPs play a tremendous role for investors and are useful to diversify issuance risk to the Treasury, members noted that the 5-year TIP is too short in maturity to attract true investment demand and that the security was primarily held and traded by speculators responding to and anticipating near-term changes in commodity prices and their commensurate effect on short-term inflation measures.

Additionally, Committee members generally agreed that the quarterly 3-year note was the next security that the Treasury should consider reducing or eliminating if borrowing needs merit a reduction in coupon issuance.

The three-year note which was only re-introduced a few years ago, has served the Treasury well over time as a security that is well received in the market but does not enjoy the same level of benchmark status as the 2-, 5- and 10-year notes. Consequently, it is a logical choice as a security to be introduced or eliminated as borrowing needs change over an intermediate period.

Alternatively, one Committee member suggested that the Treasury reduce the 10-year note in size or frequency along with the size of the 2-year note. However, there was little agreement from other Committee members who almost universally favored the reduction or elimination of 5-year TIPs and 3-year notes as needed.

A number of Committee members reiterated their belief that the bill market provides the Treasury with tremendous financing flexibility and that the Treasury should be cautious in making significant changes to the issuance calendar for notes and bonds until the need for such changes is very clear.

And, at the same time, several members stressed the importance of providing the market with advanced warning of any significant changes to the coupon calendar and the maintenance of the Treasury's hallmark of regular and predictable issuance.

In the second part of the charge, Treasury asked the Committee for its views on short-term debt management in the context of recent increased volatility of borrowing needs and cash balances.

A member of the Committee presented a series of charts depicting the volatility of current borrowing needs, the Treasury's effectiveness of managing short-term debt issuance and cash balances, the current state of preparedness in the financial system for a large-scale disruption and suggested other possible tools for Treasury to consider in the case of a contingency event.

It was pointed out that while budgetary forecasting errors have been quite significant, driven by a large number of factors, the volatility of outlays and receipts is currently near the long-term average as a percentage of output. Treasury has implemented a number of successful innovations over the past several years in the area of short-term financing including the 4-week bill program, the Term Investment Option Program and the recent launch of a repurchase agreement pilot program which have served to both minimize their cost of short-term issuance and to increase the interest earned on high cash balances.

As for contingency planning, it was noted that post 9/11 the Treasury, Federal Reserve, large member banks, primary dealers and clearing entities have upgraded capacity to deal with business continuity issues in critical lines and functions. Members discussed the idea of Treasury employing Tri-Party Repurchase Agreements for contingency planning purposes. While some members felt this tool would be more useful and appropriate than Treasury setting up a line of credit or borrowing directly from the Federal Reserve, most felt that Treasury's strongest tools in the event of a large scale disruption would continue to be the use of moral suasion and stopgap financing measures.

The third charge to the Committee centered on the competitiveness of the U.S. Treasury market and what steps, if any, could be taken to improve its position.

The U.S. Treasury market is the most liquid debt market in the world and is a benchmark against which all other debt markets are measured. The average daily trading volume in

Treasury securities exceeds $500 billion. The Treasury holds over 200 auctions a year and over 95% of the auction results are posted within two minutes.

One of the hallmarks of the Treasury market is the regular and predictable issuance pattern that the Treasury maintains and the transparency the Treasury has provided to investors and market makers. While the Committee was universal in recognizing the success the market enjoys, members pointed out that the continued success of the market is dependent on the continuation of these practices and policies. Also, technology was seen as a key focus to ensure that the auction process continues to improve both in efficiency and timeliness.

Additionally, several members stressed the importance of a “light regulatory approach” or minimal “regulatory burden” for the Treasury. This approach has served the Treasury well in the past and is increasingly important in a global and more competitive market-place.

One member noted that the Treasury has distinguished itself through the fairness it has achieved in the dissemination of information to all market participants, which is not universally seen in many foreign government markets.

One member suggested that the Treasury should not hesitate to take a stronger leadership role in world government bond markets and assist in the setting of standards and policies which benefit all market participants.

In the final section of the charge, the Committee considered the composition of marketable financing for the January-March quarter to refund approximately $35.1 billion of privately held notes maturing on February 15, 2007 as well as the composition of marketable financing for the remainder of the January-March quarter, including cash management bills, as well as the composition of marketable financing for the April-June quarter.

To refund $35.1 billion of privately held notes and bonds maturing on February 15, 2007, the Committee recommended an $18 billion 3-year note due February 15, 2010, a $13 billion 10-year note due February 15, 2017 and a $10 billion 30-year bond due February 15, 2037. For the remainder of the quarter, the Committee recommended a $20 billion 2-year note in February and March, a $13 billion 5-year note in February and March and an $8 billion reopening of the 10-year note in March.

The Committee also recommended a $30 billion 14-day cash management bill issued March 1, 2007 and maturing March 15, 2007 as well as a $10 billion 7-day cash management bill issued March 8, 2007 and maturing March 15, 2007. For the April-June quarter the Committee recommended financing as found in the attached table. Relevant features include three 2-year note issuances monthly, three 5-year note issuances monthly, one 3-year note issuance in May, a 10-year note issuance in May with a reopening in June, a 30-year bond reopening in May, as well as a 10-year TIPs reopening in April and a 5-year TIPs issuance in April.

Respectfully submitted,

Thomas G. Maheras
Chairman

Keith T. Anderson
Vice Chairman

Attachments (2)
Table Q1 07
Table Q2 07